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CORPORATE PERSONALITY IN INCOME TAXATION

I

THE principal difficulties in working out a just and consistent plan of income taxation result from the peculiar status of corporate income. To tax income to the corporation, and also to tax that income to the stockholders as dividend distributions are made from it, is to tax the same income twice. Not to tax corporate income until distributed is to postpone the tax, and perhaps never to tax it at all. To tax incomes realized by individuals carrying on business under the corporate form in one way, and incomes realized by individuals carrying on business in their individual capacity in another way, results in discrimination. This central problem is as yet far from solution, but a number of lesser difficulties resulting from the conduct of business under the corporate form have been relieved by disregarding at various points the doctrine of the separate entity of the corporation. It is the purpose of this article to discuss the instances in which this course has been followed under the present law, and to set forth reasons why the courts should sustain against constitutional attack the right of Congress in framing tax laws reasonably to draw the veil between the corporation and the stockholders. This position is maintained with full realization of the importance of adherence by the courts to the entity theory in working out problems arising from the ordinary operation of corporations.

In dealing with partnerships, except under the excess profits tax provisions of 1917, the firm has consistently been ignored as an income receiving unit. Returns have been required from partner-

ships merely for purposes of information, and the income as determined has been assessed to each partner individually according to his share.[1] Under income tax laws of the Civil War period, corporations were similarily treated. Corporations as such were not taxed, but their income as received was taxed as part of the income of the individual stockholders. In *Collector* v. *Hubbard* [2] this method of taxation was readily sustained by the Supreme Court. It is true that the court then found little difficulty with the whole problem of income taxation,[3] and that this decision was in a large part overruled by the pivotal Pollock decision by which the taxation of income from property was held to be direct taxation and hence constitutionally permissible only when the tax was apportioned among the states according to population.[4]

In the legislative consideration of the first income tax law framed under the Sixteenth Amendment, made necessary by the Pollock decision, the idea of taxing corporate income directly to the stockholders does not appear to have been discussed. This was perhaps due in part to the fact that corporations had become so numerous and their stock so widely diffused in ownership and so frequently transferred that the carrying out of such a plan as to all classes of corporations would involve forbidding practical difficulties. This law was also influenced by the English law under which the taxation of dividends as income was established. Under the pioneer law of 1913, as under the present law, corporate income was treated as in general that of a distinct taxable person, and corporate dividends as income to the stockholders.

Under the income tax statute as it stands to-day, the treatment of a corporate personality is briefly as follows:

In the normal and predominating case corporate income is taxed to the corporation as such, regardless of distribution to stockholders. Distributions to stockholders out of earnings of profits accumulated since February 28, 1913, when made in cash, are treated as income of the stockholders subject to surtax without regard to the amount of tax paid by the corporation upon the

[1] Act of October 3, 1913, D., 38 STAT. AT L. 168; Revenue Act of 1916, § 8 (e), 39 STAT. AT L. 762; Revenue Act of 1917, § 201, 39 STAT. AT L. 1000; Revenue Act of 1918, § 218, 40 STAT. AT L. 1070.

[2] 12 Wall. (U. S.) 1 (1870).

[3] Springer *v.* United States, 102 U. S. 586 (1880).

[4] Pollock *v.* Farmers Loan & Trust Co., 157 U. S. 429 (1895), 158 U. S. 601 (1895).

income from which they are paid.[5] The flat normal tax of eight per cent. (or four per cent. upon net income under $4000) levied upon individuals is, however, treated as offset in the case of dividends by the flat tax paid by the corporation, now ten per cent.[6] No provision is made for exemption of any portion of a dividend derived from income which was tax exempt to the corporation, as interest from state obligations. The exemption of distributions from earnings or profits accumulated prior to March 1, 1913, rests upon legislative policy rather than constitutional necessity.[7] The practical effect of this limitation is largely offset, so far as the phraseology of the law is concerned, by the provision that no such income may be deemed to be distributed in dividends until all earnings or profits accumulated since February 28, 1913, have first been distributed. While the law in terms taxes distributions made in the form of the stock of the distributing corporation it is of course now determined that such distributions are not income of the stockholders because the corporation does not thereby part with anything to the stockholders.[8] Distributions in liquidation or from capital are treated like payments for stock.[9]

Yet with this vigorous adherence in the normal case to the doctrine of the corporate entity there are now notable exceptions. The total exemption from tax to corporations of dividends from other corporations, themselves subject to income tax, is a relaxation from the rigors of the early attitude.

A "personal service corporation" is treated like a partnership.[10] This means that no tax is imposed upon the corporation but the entire net income is taxed as that of the individual stockholders, irrespective of its actual distribution to them. Such a corporation is defined as "one whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital . . . is not a material income producing factor." [11]

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[5] Revenue Act of 1918, §§ 213, 201, 40 STAT. AT L. 1065, 1059.

[6] Revenue Act of 1918, § 216, 40 STAT. AT L. 1069.

[7] Lynch *v.* Hornby, 247 U. S. 339 (1918); Peabody *v.* Eisner, 247 U. S. 347 (1918).

[8] Macomber *v.* Eisner, 252 U. S. 189 (1920).

[9] Revenue Act of 1918, § 201 (c), 40 STAT. AT L. 1059.

[10] Revenue Act of 1918, § 218 (e), 40 STAT. AT L. 1070.

[11] Revenue Act of 1918, § 200, 40 STAT. AT L. 1058, 1059.

In the case of a corporation formed or availed of "for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed," the excess profits tax is first imposed upon the corporation, and the income remaining after the deduction of such tax is taxed to the stockholders although not distributed to them, in the same manner as the income of a personal service corporation.[12]

Perhaps the most striking case of the drawing of the veil is in the case of "affiliated corporations," which are required to file consolidated income and excess profits tax returns in which the income and the invested capital of each are combined into a single return.[13] Two or more domestic corporations are to be deemed to be affiliated "(1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests." A combined statement made up as thus required may show a materially higher or materially lower tax than that resulting from adding together the taxes shown by separate returns for each of the affiliated corporations.

A further modification of importance is in the treatment of corporate reorganizations by which securities of a different corporation are received in place of other securities. The general rule is that "when property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value, if any." This rule is, however, made subject to the exceptions that when

> "in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged." [14]

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[12] Revenue Act of 1918, § 220, 40 STAT. AT L. 1072.

[13] Revenue Act of 1918, § 240, 40 STAT. AT L. 1081.

[14] Revenue Act of 1918, § 202 (b), 40 STAT. AT L. 1060.

This provision does not contain the clause which appeared in the bill passed by the Senate exempting from possible tax transactions by which individuals received in exchange for property owned by them stock in a corporation organized by them to take over the property,[15] although a vestige of this provision remains in the words "or property" appearing in the last line of the quotation. The Treasury Department has ruled,[16] reversing its original ruling,[17] that in such a case the individuals are liable to tax on any excess of the fair market value of the stock received over the cost to them of the property transferred to the corporation, or its value on March 1, 1913, if the property was then owned by them. This ruling, although according with the position taken by the Treasury Department under earlier laws, and finding some justification in the omission of the express exemption, is entirely inconsistent with the limitation in the law which prevents the corporation so formed from claiming invested capital by reason of the receipt of the property, to an amount beyond its cost to the individuals or value on March 1, 1913, and is inconsistent as well with the usual conception of what constitutes realization of income.

What has prompted the development of the idea of looking through the corporation has been mainly the great increase in the rates of taxation accentuating injustice of discriminations in tax burden referable to differences in the form of organization. Under the 1913 law the discrimination was not onerous. The flat rate upon individuals, like that upon corporations, was one per cent. of the net income. Exempting from normal tax dividends in the hands of individuals furnished a rough justification for collecting such a tax upon the net corporate income. It was true from the outset that a wealthy individual might escape surtax by permitting profits to accumulate for him in a corporation, but he could not get these profits out without the ultimate payment of surtax, and the rates of surtax involved were not high. The 1913 Act,[18] and also the 1916 Act,[19] did contain a provision permitting corporate income to be taxed directly to the individual if the corporation was

[15] H. R. 12,863, 65th Congress, Committee Print — as agreed to in Conference, § 202 (b), Lines 20–22.

[16] Art. 1566, Regulations 45 Rev.; T. D. 2924, Sept. 26, 1919.

[17] Art. 1566, Regulations 45, issued April 17, 1919.

[18] Act of Oct. 3, 1913, A, Subdivision 2, 38 STAT. AT L. 166, 167.

[19] Revenue Act of 1916, § 3, 39 STAT. AT L. 758.

"fraudulently" availed of for making such tax-dodging accumulations. The 1916 Act made no radical change in the treatment of the corporation, although the normal rate was increased to two per cent. for both individuals and corporations, and the maximum surtax rate was increased from six to thirteen per cent. The Treasury Department did not display in its administration of this law any feeling of need to disregard the corporate entity. Under that Act, although not until comparatively late, it crystallized its view that an exchange in reorganization of stock of one corporation for stock in a second corporation owning substantially the same assets, was an income-producing transaction.[20]

A radical change in the practical aspects of the whole question was effected by the War Revenue Act of October, 1917. In its framework that Act was an amendment of the Act of 1916. The great changes were the addition to the flat tax of a new four per cent. war income tax; the increase in the surtax rates so that they began at much lower points and (when added to existing rates) advanced to a maximum rate of sixty-three per cent.; and the imposing for the first time of a graduated excess profits tax which applied to income of corporations, as well as to other business income. Here were taxes which involved very serious discrimination due to the use of the corporate form, not to be rectified by mere exemption of dividends from normal tax.

Passed in great haste, the Act took little account in its structure of the radically changed content of the law. In the treatment of the corporate form it made but two express changes. The first of these was the inclusion of an extra tax of ten per cent. upon corporate earnings not distributed within six months after the close of the taxable year and not required for the purposes of the business[21] — a tax which proved to be impossible of administration. The second provision was that corporate dividends were to be taxed to the stockholders at rates applicable to the year in which were accumulated the earnings from which the dividends were paid[22] — a provision involving great difficulties in its practical application. The class of cases now treated on the personal service basis was

[20] BULLETIN No. 5-21, Bureau of Internal Revenue, O. D. 783; HOLMES, FEDERAL TAXES (1919), pages 304-308; MONTGOMERY, INCOME TAX PROCEDURE (1919), pages 278-281.

[21] Revenue Act of 1917, § 1206 (2), 40 STAT. AT L. 334.

[22] Revenue Act of 1917, § 1211, 40 STAT. AT L. 336.

taken in under the special rate of eight per cent., applicable alike to all businesses in which capital was nominal.[23] Corporate dividends received by corporation stockholders were exempted from the additional taxes imposed by the new Act.

Congress could make the law but the Treasury Department had to administer it. In the effort to do so the Department laid the foundations for those relaxations from the corporate entity theory which are embodied in the present law. The principal contribution of the Department by way of regulation was the idea of the consolidated excess profits tax return for affiliated corporations.[24] Once the Department had, with the assistance of its special excess profits tax advisors, faced the problem of working out the application of that tax to a group of affiliated companies, the conclusion was reached that both for the protection of the Department and of the taxpayer consolidation of income and invested capital must be provided for. Resting upon the support in the law that "all the trades and businesses in which it is engaged shall be treated as a single trade or business" [25] and that the business truth was that a single business might be carried on through a number of separate corporate forms, the Department provided that in the case of corporations defined by it as affiliated corporations there should be consolidated and not separate returns for the excess profits tax. The Department was early convinced that the method of dealing with nominal capital businesses by imposing an arbitrary rate of eight per cent. did not work satisfactory results. It also perceived the grave injustice caused under the high individual surtax rates by attempting to treat as closed transactions exchanges of securities in reorganizations, but simply passed on its convictions on this point to Congress. In the light of the experience of the Department in the administration of very high income taxes were developed the provisions in the present law under which in certain cases the corporate entity is disregarded. We now have presented to Congress, in the effort to secure further relief from discrimination, proposals for further developments along the same line.

[23] Revenue Act of 1917, § 209, 40 STAT. AT L. 307.

[24] Regulations 41, Art. 78 (1918).

[25] Revenue Act of 1917, § 201, 40 STAT. AT L. 303.

II

The power to look behind the corporate entity in taxation met verbal challenge at least in the stock dividend decision.[26] In delivering the opinion of the majority, Mr. Justice Pitney said:

> "But, looking through the form, we can not disregard the essential truth disclosed; ignore the substantial difference between the corporation and the stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge in the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized."

As to *Collector* v. *Hubbard*,[27] the court said not only that it was overruled by the Pollock decision in so far as it sustained a tax without apportionment upon the stockholders' interest in accumulated earnings, prior to dividend declared, but also that this difficulty with the decision was not cured by the Sixteenth Amendment, since the stockholders' interest in accumulated income is capital, and the Amendment applies only to income.

Opposed to the declaration of the majority is that of Mr. Justice Brandeis, who said in his dissent:[28]

> "No reason appears, why Congress, in legislating under a grant of power so comprehensive as that authorizing the levy of an income tax, should be limited by the particular view of the relation of the stockholder to the corporation and its property which may, in the absence of legislation, have been taken by this court."

The broad declaration in the opinion of the court is hardly to be taken, however, as applicable to a consistent plan for taxing in an appropriate case income of a corporation as it accumulates, as that of the stockholders. As Mr. Justice Brandeis points out, the court had in this case "no occasion to decide the question whether Congress might have taxed the stockholder upon his individual share of the corporation's earnings." Congress plainly had not done so under the statute before the court. It had treated the income of the

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[26] Macomber *v.* Eisner, 252 U. S. 189, 214 (1920). See note 8, *supra.*

[27] See note 2, *supra.*

[28] 252 U. S. 189, 231.

corporation as belonging to it and not to the stockholders, and hence as subject to tax to the corporation, and had at the same time attempted to treat a stock dividend as constituting, like a cash dividend, a distribution of those earnings constituting income to the stockholder. The decision turned upon the question of whether a stock dividend could be treated as a distribution by the corporation and was based upon

> "the essential and controlling fact . . . that the stockholder has received nothing out of the company's assets for his separate use and benefit." [29]

Now the Government contended, on the authority of the Hubbard decision, that Congress might tax stockholders on proportionate shares of the income of the corporation as they accumulated, and made the further proposition that as a matter of convenience it might collect from the stockholder, in respect to these profits, at the time when they became manifest through the stock dividend. This latter proposition found no sanction in the Hubbard decision and was completely answered by showing that the plan of the taxing act before the court was not that of taxing the income of the corporation to the stockholder as it accumulated, but the entirely different plan of taxing it to the stockholder only as it was distributed. The court might have met the point by showing that Congress could not at the same time treat corporate earnings as those of the corporation (as it did under the act in question) and also as those of the stockholder (as it did not). And in fact, notwithstanding the broad expressions above quoted, this seems to be the meaning of Mr. Justice Pitney, who went on to say:[30]

> "We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend — even one paid in money or property — can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be *separately and additionally taxed with respect to their several shares even when divided* . . ." (italics mine).

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[29] 252 U. S. 211. [30] *Ibid.*, 214.

The kind of corporation to which Mr. Justice Pitney was expressly addressing himself was one having a very large capital, carrying on a huge business involving the use of this capital and having many stockholders. While the expression in the opinion is broad, the decision is not to be regarded as controlling in a case in which the corporation has consistently and reasonably been treated, for purposes of taxation, as an association of individuals, nor is the Hubbard decision overruled as an authority that this may be done. It seems to be still open to the court to take the view suggested by Mr. Justice Brandeis that Congress, in framing tax legislation, is not necessarily committed to the separate entity theory. Determination to look through form to substance is the underlying attitude displayed in the opinion of Mr. Justice Pitney, and in the future development of the law his exact words will probably be of less importance than the general attitude which prompted them.[31]

III

There has been a vast amount of speculation as to whether a corporation is in truth an artificial person "invisible, intangible, and existing only in contemplation of law," or, less impressively, merely a mode of association of natural persons. Only a compelling taste for legal philosophy would lure a practicing lawyer into the rarefied atmosphere of such discussion. It suffices for his purposes to know that in a number of connections the courts, in dealing with corporations and stockholders, have reached results most readily explained by stating that for a limited purpose the entity was disregarded. Indeed, Mr. Morawetz was led to make his contribution to the modern law of corporations because

"The author was of the opinion that the law relating to private business corporations could not be clearly understood unless the fact was recognized that such a corporation is really an association formed by agreement of its shareholders and that the existence of a corporation as an entity independent of its members is a fiction; and that, while the fiction of a

[31] The discussion of this point is abbreviated because of the admirable treatment of it by Professor Thomas Reed Powell in "The Stock Dividend Decision and the Corporate Non-Entity," 5 Bulletin of the National Tax Association, No. 7, April, 1920. Professor Powell points out that what Mr. Justice Pitney said in the stock dividend decision was that a stockholder's interest in undivided accumulated income was to be regarded as capital, but that what the court was referring to in the Hubbard case was not accumulated income but income in the very process of accumulating.

corporate entity has important uses and cannot be dispensed with, it is nevertheless essential to bear in mind distinctly that the rights and duties of an incorporated association are in reality the rights and duties of the persons who compose it and not of an imaginary being." [32]

If the courts hold Congress in dealing with the corporation in income taxation strictly to the entity theory, they will impose restraints upon the attainment of legislative justice which they have not themselves recognized in seeking judicial justice.

Where questions of title to property or liability for debts are involved it is fundamental that the corporation be treated as a separate entity.[33] Yet even in dealing with such questions it may be found that the affairs of two corporations, or the affairs of the corporation and the stockholders, have become so intermingled that the corporate entity is not regarded.[34] If the stockholders of a corporation attempt to use it as a means of perpetrating a fraud a court of equity will take the necessary steps to prevent the fraud, and it is very likely to describe its process as one of disregarding the corporate form and looking through to the action and motives of the individuals who compose the corporation.[35] Where a corporation is used for effecting evasion of a statute, a similar result is reached.[36] Particularly where illegality is involved we may find the courts holding that the action of all of the stockholders of a

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[32] MORAWETZ, PRIVATE CORPORATIONS, 2 ed. (1886), preface; also §§ 1, 923. See also MACHEN, MODERN LAW OF CORPORATIONS, §§ 4, 20, 349, 1312. See also the interesting view as to the nature of corporations, in a letter by Alexander Hamilton, quoted in GERARD HENDERSON, THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW, page 22. Paul *v.* Virginia, 8 Wall. (U. S.) 168 (1868); Spencer, C. J., in Slee *v.* Bloom, 19 Johns. (N. Y.) 456 (1822).

[33] See *In re* Watertown Paper Co., 169 Fed. 252 (1909); Martin *v.* Development Co. of America, 240 Fed. 42 (1917); N. Y. Trust Co. *v.* Carpenter, 250 Fed. 668 (1918).

[34] *In re* Rieger, Kapner & Altmark, 157 Fed. 609 (1907); Quaid *v.* Ratkowsky, 183 App. Div. 428, 170 N. Y. Supp. 812 (1918), aff'd. 224 N. Y. 624, 121 N. E. 887 (1918); *Re* Muncie Pulp Co., 139 Fed. 546 (1905). *Cf.* Northern Pacific Railway Co. *v.* Boyd, 228 U. S. 482 (1913); Montgomery Web Co. *v.* Dienelt, 133 Pa. St. 585, 19 Atl. 428 (1890).

[35] Cuppy *v.* Ward, 187 App. Div. 625, 176 N. Y. Supp. 233 (1919); Bank *v.* Trebein, 59 Ohio St. 316, 52 N. E. 834 (1898); Lusk *v.* Riggs, 65 Neb. 258, 91 N. W. 243 (1902); Higgins *v.* California, etc. Co., 147 Cal. 363, 81 Pac. 1070 (1905); United States *v.* Trinidad Coal & Coking Co., 137 U. S. 160 (1890); McCaskill Co. *v.* United States, 216 U. S. 504 (1910); Linn & Lane Timber Co. *v.* United States, 236 U. S. 574 (1915).

[36] United States *v.* Lehigh Valley R. R. Co., 220 U. S. 257 (1911); United States *v.* Milwaukee, etc. Transit Co., 142 Fed. 247 (1905); Attorney General *v.* Central Railroad Co., 50 N. J. Eq. 52, 24 Atl. 964 (1892).

corporation, although not taken in the form appropriate to their capacity as stockholders, constitutes corporate action.[37]

Even where there is no element of fraud or evasion courts have viewed a corporation as in a particular aspect an association of natural persons rather than as a separate entity. A notable instance is the line of cases under which the federal courts took jurisdiction on grounds of diversity of citizenship of cases involving a corporation as a party.[38] Except for a comparatively brief interval, the Supreme Court did not take the view that a corporation is a citizen. The court looked instead to the assumed citizenship of the members of the corporation, and because of their individual citizenship allowed them to bring or defend in their corporate name the action of or against the corporation. This doctrine is still adhered to by the Supreme Court, although limitations, founded upon common sense, are recognized. An interesting instance of looking through the corporate fiction is the decision under which a religious corporation was allowed to hold a verdict for damages from a nuisance maintained near its religious edifice, although a material element of the damage covered by the verdict was purely personal discomfort and annoyance suffered by the members of the corporation, and necessarily not suffered by the corporation as an entity.[39]

Without attempting to go elaborately into the treatment of the corporate entity in other connections, it is clear that in considering the incidence of taxation the courts have not hesitated to look behind the corporate form. Among recent decisions is *Southern Pacific Company* v. *Lowe*.[40] Here it appeared that the plaintiff corporation owned all the stock of a second railroad company, all the property and funds of which it also held under a lease. The plaintiff company was taxed upon a dividend paid to it by the second corporation, the payment having been effected by means of

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[37] People *v.* North River Sugar Refining Co., 121 N. Y. 582, 24 N. E. 834 (1890); see also McCullough *v.* Sutherland, 153 Fed. 418 (1907).

[38] Bank *v.* Deveaux, 5 Cranch (U. S.), 61 (1809); Louisville Railroad Co. *v.* Letson, 2 How. (U. S.) 497 (1844); St. Louis, etc. Railroad Co. *v.* James, 161 U. S. 545 (1896); Doctor *v.* Harrington, 196 U. S. 579 (1905); Southern Realty Investment Co. *v.* Walker, 211 U. S. 603 (1909). For an excellent treatment of these cases see GERARD HENDERSON, THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW, pages 39–60, etc.

[39] Baltimore & Potomac Railroad Co. *v.* Fifth Baptist Church, 108 U. S. 317 (1883).

[40] 247 U. S. 330 (1918).

a credit to the plaintiff corporation on its books. The dividend was out of income accumulated prior to the year 1913. The court, although holding the view that dividends from earnings accumulated prior to the effective date of the Sixteenth Amendment were taxable, held that the dividend in question was not subject to tax for the reason that the income out of which it was declared had, under the circumstances, accrued to the plaintiff corporation in every substantial sense before the declaration of the dividend. In *Gulf Oil Corporation* v. *Lewellyn* the court extended the doctrine of this case to one in which the holding corporation which received the dividend was not the lessee of the second corporation and did not conduct its business or hold its funds.[41] In *Bank of California* v. *Richardson* the court held that a state in exercising its permissive right to tax shares of a national bank to the shareholder, might not take into account as an element of value shares of another national bank held by the bank whose shares were being valued, since this would result in twice taxing the shares of the second bank.[42] In passing on state taxing acts, however, the court fully recognizes that where under the statute it is the intention of the state to tax a domestic corporation on shares of another domestic corporation, themselves fully taxed, there is no constitutional reason why the statute should not be given effect.[43]

Even though Congress is not to be held strictly to the entity theory in dealing with the taxation of corporate income, it by no means follows that Congress may disregard this theory at will. The exercise of the taxing power, like the exercise of all other powers of Congress, is presumably subject to the limitations of the Fifth Amendment. Any taxation measures to be valid must be such as not to produce practical results which are arbitrary and without reasonable justification.[44] Those cases in which the corporation is treated as an association of stockholders and not as a separate

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[41] 248 U. S. 71 (1918); see also Alpha Portland Cement Co. *v.* United States, 261 Fed. 339 (1919); United States *v.* Oregon-Washington R. & Nav. Co., 251 Fed. 211 (1918).

[42] 248 U. S. 476 (1919).

[43] Ft. Smith Lumber Co. *v.* Arkansas, 251 U. S. 532 (1920); Cook *v.* Burlington, 59 Iowa, 251, 13 N. W. 113 (1882).

[44] For a discussion of the application of the Fifth Amendment to the taxing power, and a collection of cases bearing upon the limits of the taxing power, see "Some Constitutional Aspects of the Excess Profits Tax," 29 YALE L. J. 625 (April, 1920).

entity must belong to a class as to which such treatment is reasonable. Each instance of disregard of the entity theory must be tested for the vice of wanton discrimination.

IV

We have in the stock dividend opinion clear indication that the court does not regard it within the bounds of reason, in the case of an ordinary business corporation, to tax the income of the corporation to the stockholders as it accumulates, even though that income is not taxed at all to the corporation. The court took it to be a "practical fact" that in the case of a corporation like the Standard Oil Company of California the corporation is sufficiently real so that its stockholders cannot be considered to derive any income from its operations except as out of it actual distributions are made to them by the corporation. Even though the expressions in the opinion on this point may be distinguished from the expressions upon which the *Collector* v. *Hubbard* decision was based, the attitude shown in the opinion indicates the method sustained by the court in the Hubbard case would not be sustained to-day, at least in the case of large and active business corporations employing large capital.

This result, however, in the case of such corporations, is not inconsistent with the position that in certain classes of cases Congress may properly impose tax legislation which treats the corporation not as an entity but as an association of individuals. The Hubbard case was decided in contemplation of a very different background of facts. Corporations to-day are far more numerous than in the Civil War times; their capital is larger and their operations more extensive; and the separation of the stockholder from direct control of the corporation is, in the ordinary case, far more marked. To say to an individual stockholder of the Standard Oil Company of California that he derived income because the corporation had earned a certain amount which might, if the directors so voted, be applied in dividends on his share, would be arbitrary and unreasonable, and the tax imposed upon any such putative income should be held bad.

In contrast, however, to the protection which on any theory the courts are likely to extend to the stockholder against being

taxed upon a portion of the corporation's earnings, not effectively divided off to him, is the willingness of the courts to sustain in the normal case the taxation of income first to the corporation, and also the taxation of that income to the stockholder when distributed in the form of dividends.[45] This process involves discrimination as compared with the subjecting to individual income tax only of business income realized through a partnership or sole proprietorship, but the discrimination cannot be said to be wanton or without reasonable basis. Any additional burden so resulting is occasioned by the use of the corporate form in a state compelled to raise revenue in ways roughly practicable. This penalty is only to be removed in the future by some legislative expedient hoped for but not yet worked out in a form shown to be consistent with the need for revenue.

The situation of stockholders in a "personal service corporation" is, however, very different from the situation of stockholders in a corporation of the kind considered by the court in the stock dividend opinion. In the personal service case the income is "ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation." Such activities might well be carried on without the corporate instrumentality; incorporation in its practical aspects does little more than to bind together individual workers into a group. Furthermore, "capital is not a material income producing factor"; therefore there is not the same need which frequently exists in the case of other corporations to leave in earnings as additional capital. In such a case the owners clearly have at least as much power as ordinary partners to distribute the earnings from the business to themselves individually if they choose to do so. Under such circumstances it appears to be well within the bounds of reason to treat the corporation in its income taxation aspect as merely an association of individuals who are to be taxed individually on the share of each in the earnings as they accumulate.

The treatment in the law of the corporation "formed or availed of for the purpose of preventing the imposition of the surtax upon

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45 Lynch *v.* Hornby, 247 U. S. 339, 344 (1918): "The stockholder is, *in the ordinary case* [italics mine], a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand."

its stockholders or members through the medium of permitting its gains and profits to be accumulated instead of being distributed" has not, however, the same logical basis. In this class of cases it is equally clear by hypothesis that the controlling stockholders must have it within their power to distribute the gains or profits; otherwise it is difficult to conceive that the corporation could be found to be in fact formed or availed of for the purpose of accumulation.

In dealing with these corporations Congress was not satisfied, however, to provide merely that the corporate entity should be set aside and the income taxed as that of stockholders, as in the case of personal service corporations, but provided instead that there should first be levied upon the corporation as such an excess profits tax, and that the earnings remaining after providing for such tax should be those treated as forming part of the income of the stockholders. Here, therefore, Congress has attempted to treat the corporation as an entity distinguished from the stockholders, who, as individuals, are not subject to excess profits tax under the law, and at the same time to treat the corporation as being, for tax purposes, a mere association of individuals. All that could possibly be urged as justifying this effort to hold these inconsistent positions is the idea that in such cases the corporation and the stockholders are to be considered guilty of attempted evasion of tax and are therefore outlaws subject to any penalties which Congress chooses to impose. The difficulty with this justification is that the penalty is not in any way adjusted to the offense. Such a corporation, most clearly used as a means of avoiding surtax, might have such capital and income that there would be no excess profits tax upon it. The excess profits tax as a penalty which would apply in some cases of this method of evasion and would not apply in other equally clear cases, seems too arbitrary to stand. It seems probable, therefore, that Congress has, in shaping this provision, overreached itself and that on any theory it cannot be sustained.

The question as to the constitutional status of the provision for consolidated income and excess profits tax returns by "affiliated corporations" is more difficult. The decisions in *Lowe* v. *Southern Pacific Company* and *Lewellyn* v. *Gulf Oil Corporation* appear to indicate that the court would not have difficulty with the requirement of consolidated returns where the activities carried on by

two or more corporations legally separate are, as a practical fact, the activities of a single enterprise, or where, by virtue of decisive control, the domination of the parent corporation is clear. Under the law as it stands a consolidated return is, however, in terms required where there is substantial identity in the ownership of the stock of two corporations even though the activities carried on by each are in fact not in any sense part of the same enterprise.

In such cases, as the stockholders in their relation to the two separate enterprises have not treated themselves as a single group, there is a fair question as to whether they may be so treated for purposes of taxation. The consolidated return provision in its application to those cases in which there is directly or indirectly substantial identity of stock ownership, and also such relation between the activities of each of the corporations that they can reasonably be regarded as part of the same enterprise, should, on the grounds advocated in this article, be sustained. As in the case of public utility rate legislation, however, the court may refuse to permit the application of this broad provision in certain instances appearing to fall within its terms, where the practical consequence of so applying it is to bring about grossly unreasonable taxation.

The reorganization provision is an exemption from tax of the results of certain transactions which might, but for the exemption, be treated as yielding income subject to tax. It is difficult to see how this provision, in its main aspect, will be subject to a constitutional test. The courts of at least one state have sustained taxation of income deemed to result from the exchange of stock in a corporation formed under the laws of one state, for a similar amount of stock in a second corporation formed under the laws of another state, which took over exactly the same assets and business as those of the first corporation.[46] Possibly the comparatively small rate of taxes there involved may have assisted the court in coming to its conclusion. It is clear that this exemption rests upon sound legal theory. If a stockholder does not receive income through a stock dividend, as the Supreme Court, unlike the court of the state in question, has held, it is equally clear that the stockholder does not in any real sense receive income merely by exchanging his stock for other stock representing substantially the same thing.

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[46] Nathaniel H. Stone *et al.* Trs. *v.* Tax Commissioner, 235 Mass. 93, 126 N. E. 373 (1920); Hannah T. Osgood *v.* Tax Commissioner, 235 Mass. 88, 126 N. E. 371 (1920).

On the principles above indicated the court should refuse to sustain certain departmental rulings upon cases involving the corporate entity. One of these is the ruling above referred to, to the effect that where an individual or individuals owning property transfer that property to a corporation formed to take it over and receive stock in exchange, a realization of income may be deemed to occur. In such a case the corporation and its stockholders are so identified that the transaction should not be regarded as one producing income. An individual does not realize income through what is in practical effect trading with himself.

In the case of a corporation selling out all of its assets for purposes of liquidation, it ought also to be held, as recently contended in a case argued before the Supreme Court,[47] that there is through this disposition no realization of income both to the stockholders and to the corporation, but that only the corporation or only the stockholders should be taxed on the profit through the disposition. Where a corporation has properly determined to liquidate, it should be regarded as ceasing to function as an entity apart from the stockholders, but as acting instead as an agency of the stockholders for the purpose of realizing upon their interests in the corporate assets. The rulings of the Department are so strongly contrary to this view that where a corporation effected a formal liquidation by turning over all its property to trustees for the stockholders, and the trustees later disposed of the property, it was held that the profit on this disposition was to be taxed to the corporation, and that the stockholders were also subject to tax on their shares of the profits distributed.[48]

V

The application of drastic income taxation of corporations and individuals presents problems not thought of or considered by the courts as the theory of the separate entity of the corporation became established. Even in dealing with other questions arising from the conduct of business under the corporate form the courts have found the complexities such that while adhering to the entity theory in the main they have been obliged to depart from it, or at

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[47] Eldorado Coal and Mining Co. *v.* Mager, October Term, 1920, No. 609.

[48] CUMULATIVE BULLETIN, June, 1920, Bureau of Internal Revenue, § 1385, page 203.

least to do what they have regarded as departing from it, in order to work justice. Taxation is perhaps the most fundamental of the powers of the Government, and courts have never hesitated to emphasize the extent to which the exercise of this power may be carried upon its positive side. They should be equally anxious to set no fixed limit to the right of the taxing power to adjust taxation so that it will fall upon those who in fact bear the burden with the greatest practicable justice. Each question as to how under the plan of income taxation a corporate entity should be treated should be decided according to the court's view as to whether the effect of the treatment is grossly unreasonable and not upon any "dryly logical" application of a formula as to the nature of a corporation.

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